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LEGAL ANALYSIS OF THE GOVERNMENT SECURITIES ACT OF 1986 AND ITS APPLICATION TO BROKER/DEALERS CONVICTED OF INSIDER TRADING VIOLATIONS

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ABSTRACT

Summarizes Government Securities Act of 1986; analyzes whether it could be applied to prohibit broker/dealers convicted of insider trading violations from dealing in government securities.

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Until the Government Securities Act of 1986[1] takes effect July 25, 1987, the four major securities acts have almost no provisions aimed at regulating government securities dealers. The Securities Act of 1933,[2] which is concerned primarily with the registration of stock offerings so that sufficient financial information will be available to the investing public for it to make informed investment decisions, exempts government securities from the registration provisions:

> [T]he provisions of this subchapter shall not apply to ... [a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States ....[3]

The Securities Exchange Act of 1934[4] is concerned with many different securities requirements, such as the creation of the Securities and Exchange Commission (SEC or Commission), the regulation of the trading markets, the regulation of publicly-held companies, and the ongoing process of disclosure to

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[1] P.L. 99-571, 99th Cong., 2d Sess. (1986).

[2] 15 U.S.C. §§ 77a et seq.

[3] 15 U.S.C. § 77c(a)(2).

[4] 15 U.S.C. §§ 78a et seq.

the investing public through the filing of periodic and updated reports with the Commission. The general requirements of registration are stated to be the following:

> It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this chapter and the rules and regulations thereunder.[5]

"Exempted security" is defined to include:

> securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors....[6]

Thus, government securities at present are exempt from the registration requirements of the 1934 Act.

However, government securities were never exempted from the antifraud provision of the 1934 Act. The antifraud provision, which is section 10(b) of the 1934 Act,[7] states the following:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange...
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not

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[5] 15 U.S.C. § 78l(a).

[6] 15 U.S.C. § 78c(a)(12).

[7] 15 U.S.C. § 78j(b).

> so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

To implement this statute, the SEC adopted Rule 10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility or any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[8]

The Investment Company Act of 1940[9] requires an investment company fitting within the following definition to file various kinds of information with the Commission.[10] An "investment company" is defined as any issuer which:

> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
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> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
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> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or

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[8] 17 C.F.R. § 240.10b-5.

[9] 15 U.S.C. §§ 80a-1 et seq.

[10] 15 U.S.C. § 80a-8(b).

> proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.[11]

This provision goes on to exclude government securities from the meaning of investment securities.

The Investment Advisers Act of 1940[12] forbids all investment advisers from using the mails or any means or instrumentality of interstate commerce unless registered with the Commission.[13] An investment adviser is defined as any person who for compensation advises others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who for compensation analyzes securities; but the definition does not include certain persons such as those whose advice related solely to government securities.[14]

Thus, at present there are in the four major securities acts exemptions from the regulatory framework for government securities dealers. Only the antifraud provision of the Securities Exchange Act of 1934 applies to government securities dealers. However, on October 28, 1986, the Government Securities Act of 1986, effective 270 days after the date of enactment (July 25, 1987), imposed considerable disclosure requirements on government securities dealers.

This Act was passed in response to the failure of a number of secondary dealers in government securities between 1975 and 1985, such as Financial

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[11] 15 U.S.C. § 80a-3(a).

[12] 15 U.S.C. §§ 80b-1 et seq.

[13] 15 U.S.C. § 80b-3(a).

[14] 15 U.S.C. § 80b-2(11).

Corporation of Kansas City, Missouri; Winters Government Securities; Drysdale Government Securities; Lombard-Wall, Comark, Lion Capital Group, E.S.M. Government Securities; and Bevill, Bresler & Schulman Asset Management Corporation. The SEC estimated that between 1982 and 1986 investors lost $900,000,000 from these failures.[15] In its finding the Congress stated that:

> [T]ransactions in governmental securities are affected with a public interest which makes it necessary --
> (1) to provide for the integrity, stability, and efficiency of such transactions and of matters and practices related thereto;
> (2) to impose adequate regulation of government securities brokers and government securities dealers generally; and
> (3) to require appropriate financial responsibility, recordkeeping, reporting, and related regulatory requirements.[16]

The major operative provision of this Act makes it unlawful for any government securities dealer or government securities broker to use the mails or any means of interstate commerce to effect any transaction in any government security unless the broker or dealer has registered with the SEC.[17] Further, a registered broker, dealer, or financial institution is prohibited from using the mails or any means of interstate commerce to effect any transaction in any government security unless it has filed with the appropriate regulatory agency written notice that it is a government securities broker or government securities dealer.[18] The SEC is required to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding

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[15] Senate Report No. 99-426, 99th Cong., 2d Sess. (1986), at 6.

[16] P.L. 99-571, § 1(b).

[17] P.L. 99-571, § 101, codified at 15 U.S.C. § 78o-5(a)(1)(A).

[18] P.L. 99-571, § 101, codified at 15 U.S.C. § 78o-5(B)(i).

twelve months, or revoke the registration of a government securities broker or dealer if it finds that such sanction would be in the public interest and that the government securities broker or dealer or any person associated with it has committed or omitted any specified act, such as the filing of false or misleading registration statements with the Commission, violation of any of the provisions of the four major securities acts, or conviction within ten years of any felony or misdemeanor involving the purchase or sale of any security or has been permanently or temporarily enjoined from acting as an investment adviser, broker, dealer, or person required to be registered under the Commodity Exchange Act.[19] The Government Securities Act of 1986 also makes conforming amendments to present securities statutes[20] to reflect registration requirements.

It would appear that the sanctions provision in the Government Securities Act could be applied to brokers or dealers who have been convicted of insider trading violations in order temporarily or permanently to prevent them from effecting any transactions in government securities. In fact, the provision appears to require the SEC to impose some kind of sanction against a government securities broker or dealer if it has been convicted of a felony or misdemeanor in relation to the trading of securities and if such a sanction would be in the public interest.

Violation of the insider trading laws by a government securities broker or dealer would appear to fall within parameters of this sanction's provision. There are three major statutes which are used in finding insider trading

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[19] P.L. 99-571, § 101, codified at 15 U.S.C. § 78o-5(c)(1).

[20] P.L. 99-571, § 102.

violations: (1) Section 16[21] of the 1934 Act is designed to discourage corporate insiders from using inside information to make short-swing profits. Any director, officer, or ten percent shareholder of a corporation registered with the SEC who realizes any profit from any purchase and sale or sale and purchase of any equity security of the company within a period of less than six months must turn over the profit to the company. Section 10b of the 1934 Act and Rule 10b-5, previously discussed, have been used as sanctions against those who trade securities with the advantage of inside information. This statute and rule were interpreted broadly for approximately thirty-five years, but the trend now is toward a more narrow reading. The Supreme Court has held that fraud does not include overreaching by a controlling shareholder unless there is actual deception and that there must be scienter (knowledge) in order to hold a person liable for damages.[22] Further, there must be a duty to disclose,[23] and there must be a fiduciary relationship[24] for a violation to have occurred. In 1984 Congress passed the Insider Trading Sanctions Act.[25] This Act amends, among other provisions, section 78u of the 1934 Act to provide that a person who is convicted of violating the insider trading provisions may be fined up to three times the profit gained or loss avoided as a result of the unlawful purchase or sale of securities.

Other statutory provisions may now be used in sanctioning registered brokers or dealers convicted of insider trading violations. For example, under

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[21] 15 U.S.C. § 78p.

[22] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[23] Chiarella v. United States, 445 U.S. 222 (1980).

[24] Dirks v. SEC, 463 U.S. 646 (1983).

[25] P.L. 98-376, 98th Cong., 2d Sess. (1984).

the Investment Company Act certain persons are prohibited from being affiliated with an investment company. They include any person convicted within the past ten years of a security-related felony or misdemeanor, one who has been permanently or temporarily enjoined from acting as an underwriter, broker, dealer, or investment adviser, one who has made a false or misleading statement in a registration statement, or one who has willfully violated the 1933 or 1934 Acts.[26] Sanctions also can be applied under the Investment Advisers Act to registered investment advisers convicted of certain securities law violations, including, presumably, insider trading.[27]

We have been informed by the Office of General Counsel at the Securities and Exchange Commission that thus far only individuals, not securities firms, have been charged with insider trading violations in the recent spate of Wall Street scandals. Most, if not all, of these individuals will likely be prohibited from securities trading activities, including trading in government securities, as discussed in the above statutes.

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[26] 15 U.S.C. § 80a-9.

[27] 15 U.S.C. § 80b-3(e).